THE HONORABLE MARSHA J. PECHMAN

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

IN RE: WASHINGTON MUTUAL MORTGAGE BACKED SECURITIES LITIGATION

This Document Relates to: ALL CASES

Master Case No.: C09-0037 (MJP)

PLAINTIFFS' REPLY TO DEFENDANTS' OPPOSITION TO MOTION TO PRECLUDE THE PROFFERED EXPERT TESTIMONY OF CHRISTOPHER JAMES, Ph.D.

Note on Motion Calendar:
July 20, 2012

ORAL ARGUMENT REQUESTED

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TABLE OF CONTENTS

Page

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TABLE OF AUTHORITIES

Page(s)

CASES

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INTRODUCTION

Defendants have put forth no valid argument as to why Christopher James should be permitted to testify or to offer his opinions as to "negative causation under Section 11." Dr. James' opinions are unreliable and irrelevant. Plaintiffs respectfully request the court enter an order precluding his testimony in this action.

ARGUMENT

I. Shifting Positions On the Standard Applied to Test for Corrective Disclosures

Defendants' first argument for the admissibility of Dr. James' testimony is that in forming his negative causation opinions he actually looked for "corrective disclosures" that related to more than Defendants' repeated and minimalistic interpretation of the case (whether WaMu "abandoned its underwriting" or whether underwriting standards "ceased to exist"). As background, Plaintiffs described how Dr. James' opinion relies upon an overly narrow summary of the claims of the case. In response, Defendants claim that Dr. James actually reviewed sources related to "either an abandonment of underwriting standards or to a general loosening of underwriting standards at WMB." Defendants' Opposition to Plaintiffs' Motion to Exclude the Testimony of Christopher James ("Dr. James") (ECF No. 478) ("Def. Br.") at 3. In support of that argument, however, Defendants cite to a highly misleading quotation from Dr. James' deposition wherein he claims that he saw "no evidence of a disclosure that indicates that heretofore undisclosed relaxation in underwriting standards are causing losses or leading to a decline in the value of *these securities at issue in this case*." *Id.* (emphasis added). This deposition excerpt actually reveals Dr. James' minimalistic approach to loss causation that is wholly inappropriate.

In this quotation, Dr. James "explains" that he looked for disclosures surrounding relaxation of underwriting standards that were specifically tied to the loans at issue in this case. He concludes that he found no single disclosure saying that the underwriting standards were relaxed in connection with Plaintiffs' specific loan pools. This, however, is neither the theory of

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Plaintiffs' case nor the appropriate standard of analysis for loss causation purposes. It is, instead, an exacting and restrictive view that finds no basis in the law.

The law is clear that if the market learned any aspect of the truth or if the truth began to "leak" out, that is sufficient for loss causation purposes. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 342 (2005). Plaintiffs have alleged that the truth began to leak out as early as 2007, although not in the manner that Dr. James suddenly insists is necessary. Ironically, in his first expert report in this case, Dr. James actively espoused this same rationale for imputing knowledge of WaMu's weaker underwriting to investors who purchased late in the class period when seeking to demonstrate their "differential knowledge" for purposes of defeating class certification:

> Increased knowledge of the alleged underwriting deficiencies can be imputed to plaintiffs who purchased later in the putative class period due to availability of additional information regarding mortgage group/security performance relative to expectations, as well as public discussions regarding mortgage performance and the potential role of underwriting issues.
>
> * * *
>
> Given these data and discussions, it is reasonable to assume that putative class members, particularly sophisticated putative class members, may have drawn inferences about underwriting practices from the performance data that they received. Differential knowledge for certain later purchases can also be imputed from lower prices and ratings downgrades.

See excerpts of Expert Report of Prof. Christopher M. James, dated June 22, 2011, (ECF No. 278), ¶¶89, 97. Yet Dr. James now espouses precisely the opposite to advance Defendants' desired loss causation opinions; *i.e.*, that this revealed information did not correspond to any losses.

Now, according to Defendants, Dr. James meant to say that he found "no evidence" of any disclosure linking WMB's "loosening" of underwriting standards to the higher defaults on the mortgages in this case. Dr. James' original thesis that some in the market may have begun to suspect that the higher losses in the offerings were caused by WMB's generally loosened

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underwriting – and that this was enough to show loss causation – is on all fours with *In re Daou Systems, Inc.*, 411 F.3d 1006, 1026-27 (9th Cir. 2005), where the earnings surprise led certain market analysts to "speculate" that the company was cooking the books, and particularly with *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049 (9th Cir. 2008). In *Gilead*, there was a disclosure of practices that did not cause a market reaction, but later reported lowered revenues that linked the two did. The Ninth Circuit found this sufficient for loss causation purposes.

Here, in 2007, disclosures concerning suspect underwriting with respect to subprime loans entered the market. In 2008, disclosures were made regarding poor underwriting for option ARM loans. For example, the April 14, 2008 *Seattle Times* article specifically discusses loosened lending standards, limited documentation, "liar loans," quantity over quality, and greater risk tolerance in regards particularly to option ARM loans. *See*, Exhibit 83 to Dec. of John T. Jasnoch in Support of Plaintiffs' Opposition to Defendants' Motion for Summary Judgment (ECF No. 418-5). Additionally, in 2008, there was an increase in defaults in Plaintiffs' loan pools. The increase began to raise questions as to whether those defaults were due to the same problems disclosed as early as 2007. It is the combined events that demonstrate loss causation here.

Plaintiffs have not alleged, nor need they, that there was a single corrective disclosure specifically related to their loan pools and relaxed underwriting standards. In fact, the law is patently clear that, even after the decision in *In re Oracle Corp. Sec. Litig.*, No. C 01-00988 SI, 2009 WL 1709050 (N.D. Cal. June 19, 2009), the decision so vigorously pressed by Defendants to entitle them to summary judgment, there need not be a complete disclosure that links up perfectly to the loss at issue, as Dr. James now seems to opine. For example, in *Richard v. Northwest Pipe Co.*, No. C9-5724RBL, 2011 WL 3813073 (W.D. Wash. Aug. 26, 2011), this Court specifically noted that, as to loss causation, "[t]he truth need not be disclosed through a single, complete disclosure." *Id.* at *3 (citing *In re Daou Sys.*, 411 F.3d at 1026-27). Similarly, in *Teague v. Alternate Energy Holdings, Inc.*, No. 1:10-cv-00634-BLW, 2011 WL 6337611, at

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*5-*6 (D. Idaho, Dec. 19, 2011), a court held that the defendants there were insisting on too simplistic of a loss causation analysis and overlooking the Ninth Circuit's analysis in *Gilead*. Finally, in *In re Homestore.Com, Inc. Sec. Litig.*, No. CV 01-11115 RSWL, 2011 WL 1564025, at *2 (C.D. Cal. April 22, 2011), the court found that a disclosure "need only reveal an aspect of the fraud" and that loss causation there was shown by the surprise of market analysts in reaction to press releases. *See also Plumbers' Union v. Nomura Asset Acceptance Corp.*, 632 F.3d 762 (1st Cir. 2011) (linkage between the general disclosure of poor underwriting and the offerings was shown by a sharp decline in credit ratings).

In sum, even with the third iteration of Dr. James' opinion, he still performed an analysis that was too narrow under the law. He failed to take into account the applicable standard for loss causation purposes when there is a disclosure and a later event that, coupled together, caused the market to react. His opinion is thus, as a legal matter, irrelevant.

II. Defendants Cannot Excuse Errors in Comparables

Defendants next try to maintain the admissibility of Dr. James' testimony by claiming that his comparables are adequate, and that their inclusion does not affect his negative causation opinion. Neither argument holds water. Defendants first argue that inclusion of Countrywide and IndyMac by Dr. James as comparables was appropriate because he had seen "no evidence" that underwriting standards at those companies ceased to exist. Def. Br. at 7. This, however, is simply nonsense. Despite Dr. James' denials, however, in his deposition in this case, he grudgingly admitted that he had, in fact, known about the Inspector General's "material loss review" on IndyMac, which concluded that IndyMac had failed, in part, as a result of its deficient underwriting. Declaration of Amanda F. Lawrence in Support of Plaintiffs' Reply to Defendants' Opposition to Motion to Exclude the Proffered Expert Testimony of Christopher James ("Lawrence Decl."), Exh. 1 at 103, 105-08; and he similarly knew of the proposed $8.5 billion settlement involving Countrywide's violations of its underwriting representations. *Id.* at

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148-49. Dr. James also admitted knowing about the *Seattle Times* article dated January 15, 2008 discussing Countrywide's reduced documentation (or "liar" loans). *Id.* at 116.

Furthermore, Defendants focus only on the inclusion of Countrywide and IndyMac offerings as comparables and claim that removal of those two do not change Dr. James' conclusion that WMB loans somehow still performed as well as or better than the comparison loans. As a preliminary matter, Defendants have provided no support for this analysis that removes the billions of Alt-A offerings by IndyMac and Countrywide. Should the Court permit Dr. James to testify, Dr. James should be required to produce the back up for this suspect analysis. However, regardless of whether Dr. James' back up does what he says, this argument still fails for numerous reasons. First of all, Countrywide and IndyMac are only two of the inappropriate comparables considered by Dr. James. In fact, Dr. James was shown a list at his deposition of his comparable loan originators and specifically testified that a great number of them had filed for bankruptcy, had their assets seized, or employed underwriting practices that lead to their own demise. *Id.* at 134-38. Therefore, removal of Countrywide and IndyMac alone would not change the corrupted nature of the remaining comparables. Their removal would likewise be inadequate because many of Dr. James' other comparable offerings included a significant number of loans actually originated by both Countrywide and IndyMac.

In conclusion, the entire basis of Dr. James' conclusion is a comparison to the industry. He uses this comparison to conclude that, based on the performance of comparables, WMB loans performed on par with industry standards. His basis, however, cannot possibly stand because he completely fails to take into account that virtually every issuer or originator in his sample was subject to allegations of improper, deficient or fraudulent underwriting practices— *i.e.* the entire industry is thus both suspect and contaminated. As opined and demonstrated by Plaintiffs' expert, Dr. Adam Levitin, "degradation of underwriting guidelines was endemic throughout the industry" and "it's not at all surprising that Washington Mutual's loans performed similarly to the

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rest of the industry. They're all poorly underwritten essentially…." Lawrence Decl., Exh. 2 (Deposition Transcript of Adam Levitin), at 7:24-25; 8:2-5.

As the Court held in *Securities & Exchange Commission v. Pimco Advisors Fund Management*, 341 F. Supp 2d 454, 471-72 (S.D.N.Y. 2004), the idea that "everyone was doing it" is not a viable defense to a charge of securities fraud. Therefore, Dr. James' opinion as to negative causation is unreliable and irrelevant because he fails to account for certain fundamental realities in his comparables pool. *See, e.g., R & R Intern., Inc. v. Manzen, LLC*, No. 09-60545-CIV, 2010 WL 3605234, at *13 (S.D. Fla. Sept. 12, 2010) (expert's testimony excluded as unreliable due to comparables as "…sampling choice lies at the heart of an expert's methodology"); *Loeffel Steel Products, Inc. v. Delta Brands, Inc*., 387 F. Supp. 2d 794, 812 (N.D. Ill. 2005) (expert testimony on economic loss barred due to choice of comparables); *Cayuga Indian Nation of New York v. Pataki*, 83 F. Supp. 2d 318 (N.D.N.Y. 2000) (expert opinion excluded as unreliable and irrelevant due to comparable).

III. New Explanation of Default Rate Predictions

Defendants' final argument for the admissibility of Dr. James' opinions concerns his default rate predictions. In their moving brief, Plaintiffs pointed out that his default rate predictions did not add up to the actual default rates, as they are required to. In their brief, Defendants *admit* that the rates must sum one another. In the face of this error which Plaintiffs' experts discovered, Defendants then suggest a new explanation: that it is only when grouping together the WMB loans and the non-WMB loans that the actual and predicted rates do not add up. Def. Br. at 11-12. It is simply too late for Dr. James to rewrite his opinion.[1]

CONCLUSION

For the reasons stated herein, Plaintiffs respectfully ask that this Court preclude the report and testimony of Defendants' proffered expert, Dr. Christopher James.

[1] If Dr. James is permitted to again shift his opinion to correct his errors, he should be ordered to produce his support, including the evidence of when it was prepared.

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Plaintiffs respond to and again request that the Court enter an order precluding the testimony of Dr. James as to "negative causation" under Section 11. As described in Plaintiffs' moving brief dated July 2, 2012 (ECF No. 457) and herein,

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